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Fair Credit Reporting Act: How it Functions for Consumers and the Economy

I. Introduction

Thank you Mr. Chairman, Ranking Member Sanders and members of the Subcommittee. My name is Kevin Sullivan. I am the Vice President and Deputy General Counsel of Government Relations at the Allstate Insurance Company. I appreciate the opportunity to provide you with an overview of insurance scoring and to discuss why and how this competitive innovation benefits consumers.

I would like to summarize the role of national uniform standards in creating a robust insurance market for consumers, and how such uniformity affects insurance availability and affordability. I will also discuss the correlation between insurance scores and insurance underwriting, and how this issue has evolved under the Fair Credit Reporting Act. Finally, I will discuss how the myriad of state legislation and regulation in the credit arena have made it more difficult for insurers to provide the best in the way of affordability and availability to consumers.

II. Applicability of the FCRA to Insurers

The Fair Credit Reporting Act has recognized the use by insurance companies of credit information since its enactment in 1970. The use of consumer reports in connection with the underwriting of insurance has been a permissible purpose under the Fair Credit Reporting Act for over 30 years.

When the Fair Credit Reporting Act was amended in 1996, national uniformity was achieved by removing certain matters from the ambit of state regulation. Those national uniform standards or preemptions, which cover information in consumer reports, timing for resolving disputes, adverse action duties, the obligations of those who furnish information to credit reporting agencies, consumer rights notices, pre-screening, and affiliate sharing of information, will sunset on January 1, 2004 unless Congress extends or reauthorizes them.

Since the 1996 amendments were enacted, the insurance industry has begun to more fully utilize credit history as a predictor of future losses. This has resulted in substantial consumer benefits by allowing insurers to offer coverage at lower premiums to those whose credit report indicates they will be less likely to incur losses.

III. Overview of Insurance Scoring

The use of credit-based insurance scoring is the most significant advancement in cost-based pricing in at least the past 30 years. Insurance scores are derived from information contained in credit reports and are used to help insurance companies determine which risks to accept and how to allocate premium accurately among the risks that are accepted.

Insurance scoring is good for consumers, insurance agencies, insurers, and the marketplace. It allows insurers to reward customers in already-existing risk pools with lower premiums, and to write more consumers than they otherwise would. Insurance pricing and actuarial science is based upon the fundamental belief that premiums should be related to risk of loss. Using insurance scoring as part of cost-based pricing results in premiums that more accurately reflect risk of loss for each consumer, thereby reducing subsidies, which effectively are hidden taxes.

Insurance scoring allows more opportunity for individuals to be charged relatively lower premiums based on behavior they can control. In addition, even those who are not initially charged lower premiums benefit because insurance is more available to them and because they may be less likely to be non-renewed. Information that is accurate, predictive, and difficult to falsify is absolutely critical for appropriate underwriting and rating. The greater the accuracy and reliability of the available data, the more healthy the marketplace for insurance, which means lower costs, greater availability, and more stability for the consumer.

Information obtained from credit reports is information that helps insurers more accurately determine the cost of insurance, thus driving down prices and creating greater stability in the marketplace, which benefits everyone.

IV. History of Insurance Scoring

The predictive power of information included in credit history has been known since at least 1968, when the Washington State Department of Motor Vehicles reported a correlation between credit history and auto accidents, but its modern use can be traced to the late 1980’s, when Fair Isaac, a leading provider of insurance scores to many insurers in the industry, began developing scoring models based on credit history. Allstate began using its own models during this time as well.

In the early 1990’s, Allstate began using information included in credit history to help evaluate all auto and homeowners risks in nearly every state. At that time, we only used information included in credit history to help us determine who we could afford to write, but as we learned more, we realized that by using this information and knowledge to help us set premiums, we could afford to write more consumers and we could reward consumers less likely to incur insurance losses with lower premiums. In 1999, we began using information included in credit history to help us determine premiums, and we now use this predictive information for some combination of underwriting and premium determination in almost every state.

While credit-based insurance scoring provides valuable information and knowledge that insurers use to more accurately assess the likelihood of insurance losses, it is generally **used in addition to, not instead of, other information.**

Insurance scoring models generally consider aspects of a consumer's credit management history related to the presence of public records, collections or delinquencies, number of accounts of various types, length of account history, frequency of non-promotional inquiries into the credit report, and credit utilization (account balances relative to limits). Insurers have found that these specific characteristics, when used together, are very predictive of insurance losses.

Allstate uses a scorecard approach, where particular attributes of a consumer's credit report (e.g., number of collections) receive a score. The total insurance score for the credit report is an aggregation of all the individual attribute scores. An attribute can be assigned either a positive or a negative insurance score. This allows positive attributes to offset negative ones, and gives us a more holistic assessment of a customer's insurance score as it relates to insurance loss potential. This means that the presence or absence of any particular attribute will not necessarily preclude anyone from qualifying for the tiers associated with the lowest premiums.

The characteristics that are considered and used in our scoring process are not the same as would be used to evaluate credit worthiness or the ability to pay insurance premiums. Rather, we consider only information that we have found to be significant predictors of insurance losses. In addition, while a credit report may be used by a lender to make a decision to accept or reject a request for credit, Allstate's scoring model is designed to create several different levels of distinction, including distinctions between varying degrees of excellent scores.

Banks and insurance companies use information contained in credit reports for very different purposes, so it is not surprising that a positive decision by one does not mean a positive decision by the other. Banks are concerned about ability to re-pay the loan. Insurance companies are concerned about the likelihood of loss. The reason that insurers and lenders might make different decisions based on the same credit report is that they are using information in the same credit report for very different purposes. When looking at an individual's credit report, banks look to an applicant's income, financial obligations and collateral to assess the likelihood of repayment. Insurers, however, do not consider income in the analysis of credit information. Rather, insurers only seek to evaluate an individual's handling of financial obligation to glean information on the likelihood of future insured loss claims.

V. Insurance Scoring Predicts Losses

The relationship between credit history and insurance losses is not a matter of theory or conjecture, but of statistical reality and fact. State insurance regulators have recognized the strong correlation between credit-based insurance scores and future insured losses. In fact, Mike Pickens, Arkansas insurance commissioner and current National Association of Insurance Commissioners president, has stated that insurance scoring is colorblind and is valid and credible, pointing to a recently released University of Texas study showing a high correlation between credit scores and frequency, probability and degree of loss.

Allstate's observations of its own actual loss experience confirm the relationship between insurance scoring and insurance losses. Allstate has been evaluating the use of credit history information and the ability to use this information to predict insurance loss ratios since the 1990's. We have seen, and continue to see, an extremely strong correlation between information included in a person's credit report and the likelihood of insurance losses. Auto insureds in the worst 10% of insurance scores incur over 60% more losses than those in the best 10%. This correlation is even stronger in the homeowner arena, where insureds in the worst 10% of scores incur well over twice as many losses as those in the best 10% of scores. Customers less likely to incur losses should not have to bear the burden of subsidizing customers more likely to incur losses. Our use of insurance scoring helps us address this inequity and reward customers likely to incur fewer or lower losses with lower premiums.

For us, what matters is that certain information in credit history predicts losses and that its use allows us to provide more consumers with insurance at lower prices. In the face of irrefutable data based on actual loss experience, some critics at the state level continue to question the value of this knowledge. We find this surprising because the link between credit history and loss potential has been studied extensively by many scholars independent of the insurance industry, in fields such as psychology, safety engineering, occupational medicine, consumer research, and risk perception.

Over 30 articles and studies that we have analyzed point to two possible explanations. One explanation relates to risk-taking behavior. Different people have different aversions to risk. Some people like to skydive. Some people are afraid of the amusement park roller coaster. Some people will run a yellow light if it was yellow when they first saw it. Some people will stay under 55 miles per hour on the highway. People who are more likely to take risks are more likely to get into serious financial difficulties (bankruptcies, liens, foreclosures, etc.) than those who are more risk averse. As the studies show, people who are more likely to take risks are also more likely to get into auto accidents. Therefore, some people with poor scores are more likely to engage in risky behavior and thus more likely to incur losses. Another explanation relates to stress. People under stress are more likely to have auto accidents. They may be more easily distracted or not react as well to certain situations. Difficulty in the management of one's financial assets is a known cause of stress. Therefore, some people with poor scores are more likely to experience stress and thus more likely to incur losses.

Neither, either or both of these theories may be true for a particular individual. In some instances, financial difficulties might not be caused by risk-taking behavior but will still produce stress. In other instances, however, it is the risk-taking behavior rather than stress that leads to a greater likelihood of loss.

Other theories have also been offered to explain why insurance scoring predicts insurance losses. Some believe that credit history may reflect personal responsibility and that it is intuitive and reasonable to believe that the responsibility required to prudently manage one's finances is associated with other types of responsible and prudent behaviors, such as proper maintenance of homes and automobiles and safe operation of cars. Others have suggested that if people take care of their most important asset--their finances--they are likely to exercise the same amount of responsibility in other areas of their lives; they're also more likely, if they have a minimal loss, to pay for the loss themselves. Another theory is that financially stable individuals are likely to exhibit stability in many other aspects of their lives. We are not aware of a body of research that supports these theories, unlike the voluminous research that supports the risk-taking and stress theories, but that does not mean that these alternative explanations are necessarily invalid.

Allstate's use of insurance scoring as a risk evaluation tool is based on the fact of its predictive power, not on the explanation for its predictive power. Insurance pricing based upon valid and credible data and actuarially sound methodology has never been asked to support **why.** Rather**,** it is just required to mirror **what is**. Just as we all recognize the fact that apples fall down from trees despite the fact that scientists have yet to fully explain how gravity works, Allstate must recognize and cannot ignore the fact of the predictive power of insurance scoring--customers less likely to incur losses would pay for our overlooking this undeniable fact. Insurance scoring is colorblind and is based upon risk criteria that consumers can control—specifically, the management of their financial obligations. Nevertheless, we do take great comfort in the fact that there is such strong, intuitively satisfying support for the link between information in credit history and loss likelihood contained in the academic literature mentioned above. Even in the absence of such compelling explanations and academic support, the case for using insurance scoring as a risk evaluation tool would remain just as strong.

Scientific and logical explanations, while comforting, are not always available to support that which we know to be fact. For example, if I were to tell you that there was a group of drivers who had superior eyesight, superior hearing, more stamina, sharper reflexes, needed less sleep, and had greater athletic ability than other drivers, and that drivers within this group had in addition just completed a safe driving course, you might think that these drivers would be less likely to have accidents than others on the road. However, we've actually identified this segment of the population—they are young male drivers, and they are actually much more likely to have accidents. You might guess that the factor that outweighs all these other factors is maturity (or the lack thereof), but insurance companies have no data showing that maturity outweighs all these other factors. All we have is clear data showing a correlation between young male drivers and insurance losses. Our decision to charge young males more is based solely on actual loss experience, the same data and the same analysis we use for insurance scoring. The correlation between the information contained in credit history and insurance losses is even stronger, and the fact of its predictive power would and in fact does stand independent of the explanations that exist to support it.

VI. Insurance Scoring Benefits Consumers

Insurance scoring benefits the insurance-buying public because it allows insurers to write more insurance, because it increases the accuracy of risk evaluation, and because it allows insurers to reward consumers who are less likely to incur losses with lower premiums. Historically approved factors such as age, sex, marital status and territory have been criticized in the past because even though those factors are predictive of losses, consumers have little or no control over them. An insurance score is related to risk behavior that consumers exhibit, characteristics they can control, yet it is also an objective and uniformly applied criterion.

The rationale for insurance scoring is the same as for all other cost-based pricing variables: those less likely to incur losses should pay less for insurance. Allstate wants to write as much profitable business as it can. We are a publicly traded company that is committed to profitable growth. The personal lines insurance business is highly competitive. Through our use of insurance scoring, we can write more business than we otherwise would, and reduce subsidies among the business we do write; if we were to lose this tool, we would be forced to write less business and reintroduce pricing subsidies. The net effect of our use of insurance scoring is that more people are written and get the benefit of lower rates because our ability to consider information included in credit history allows us to relax other underwriting standards. We can do this because our use of insurance scoring allows us to create further risk segmentation and identify more business that we can write. In addition, customers less likely to incur loss can qualify for lower rates.

By providing consumers with more prices to choose from, companies can write more business. About 20% of the standard auto business Allstate has written since it began using insurance scoring would not have qualified under Allstate's previous underwriting guidelines. By using insurance scoring in addition to other factors, Allstate has been able to relax its underwriting guidelines and provide more choices for consumers. As a result, we have been able to write more business.

When insurers must decide which, if any, of its customers to non-renew, such decisions are based on a re-assessment of risk of loss going forward based on either new data or new methods of considering existing data. To the extent that insurers have more confidence that they have properly evaluated a risk, they are more likely to continue insuring that risk. The use of information included in credit reports as a risk evaluation tool can increase such confidence.

Because the use of information in credit history allows insurers to create a more accurate tiering structure, insurers can initially offer tiers that anticipate a certain amount of loss, thus alleviating the risk of non-renewal. For example, a company with no tiers might accept risks with no losses in the past three years, and then find itself having to non-renew customers who experience losses because the company's preferred rate structure is not designed to accommodate customers who have recently incurred losses (because such customers are more likely to incur losses in the future).

But a company with a tier structure designed to accommodate greater risks might, by using information included in credit history as one of its criteria, be able to identify customers with no losses in the past three years who are nevertheless more likely to incur losses. By putting such risks into a higher-priced tier that is designed to accommodate these higher costs, such a company might not have to non-renew someone who incurred a loss because this additional fact, indicative of greater losses, had already been priced for, and thus the risk presented had not changed. Cancellation or non-renewal is simply not a good thing to happen to consumers, and our use of insurance scoring makes it less likely that such actions will occur.

Reducing the likelihood of non-renewal results in less customer disruption, and also helps prevent customers from being non-renewed. In certain states, insurers may underwrite against consumers who have previously been non-renewed, which is another reason that a less disruptive renewal program, made possible by the increased information and certainty provided by credit history, helps consumers.

VII. The Problems Caused by State Legislation and Regulation of Credit Reports

The benefits to insurance consumers from the use of information included in credit reports are clear. But as more and more insurance companies realize the value of certain information included in credit reports, credit information usage has come under fire in many states. Political considerations have often dominated the process. The outcome has been inconsistent and very costly. The Fair Credit Reporting Act requires that we send notices of adverse action to anyone who does not receive our best credit-based rate, which means that even someone whose premium is lowered by our use of insurance scoring will get an adverse action notice if the premium is not the lowest credit-based premium we offer. Someone who yesterday would not have even qualified for our preferred company, but who today qualifies at a rate lower than what he would have paid in another company (but not at the best credit-based rate we offer in the preferred company) will receive such a notice, even though he is paying less than he did before and is actually benefiting. We do not object to sending these notices because they help consumers identify potential errors in their credit reports, which is consistent with the goals of the FCRA. In fact, proposals to enhance the notice to ensure that uniform and consistent notice is provided in every state may have merit; however, a political process that produces inconsistent and expensive requirements or restrictions does not.

Unfortunately for consumers, the use of information included in credit reports by insurers has become an easy political target. One state legislator told us that the safest votes a politician can make are for longer prison sentences and for restrictions on insurance companies!

In each of the past three years, including 2003, approximately 40 states have considered restrictions on the use of information included in credit history. Since May 1, 2002, only one year ago, over 30 new state laws affecting how insurance companies use information included in credit reports have or will become effective, ranging from complete bans for certain lines to substantive restrictions of varying degrees (such as what information can be considered and in what manner). It is too early to measure the actual results of this political interference with the marketplace, but we know that Maryland's recently enacted ban on the use of credit information by insurers for homeowners insurance is already causing more subsidy to be built into rates and contraction in the homeowners insurance market. Inconsistent and onerous restrictions on the use of information contained in consumer reports could have the effect of eliminating insurance underwriting as a "permissible purpose" under the FCRA regulatory structure—at least for some competitors.

It is almost axiomatic that if insurance companies are denied access to information and knowledge relevant to the risk of loss, or if insurance companies must comply with notice requirements that vary from state to state, costs will be added to the system and the marketplace will not function as efficiently. The result will be some combination of less availability and higher prices, exactly the opposite of what consumers truly want. Such unpredictable, inconsistent, complex and expensive state regulation of the use of credit history by any other financial services segment would be seen as inefficient and unfair and as undermining the FCRA structure.

The prohibitions and restrictions adopted by states deny consumers the benefits of innovation, vigorous competition and more choice in the marketplace. The use of information included in credit history by insurers may have only been a blip on the radar screen in 1996, but today it benefits millions of consumers, and its benefits are at risk. Attached is a list of states that have enacted laws that create inconsistency, complexity and expense. Politicians in the states have been very active, and their colleagues at the municipal level could enter the fray some day soon as well.

VIII. Conclusion

The Fair Credit Reporting Act has provided national uniformity and consistency with regard to the use of credit reports by insurers, particularly with regard to pre-screening, marketing, and adverse action notices. Such uniformity is necessary to allow the marketplace to operate to the benefit of consumers. Unfortunately, it has become increasingly apparent in recent years that regulation of insurance at the state level can, and in fact has, subverted this system of uniformity, particularly with regard to the use of insurance scoring. Consumers of insurance are the only customers of major financial institutions not fully protected by the Fair Credit Reporting Act.

Existing preemptions serve to protect consumers who use services provided by other financial services industries from state regulation because the use of consumer reports is much more efficiently regulated at the federal level. The Fair Credit Reporting Act clearly contemplates the use of credit reports by insurers, as such use has been a permissible purpose since 1970. However, the use of information included in credit histories by insurance companies has grown significantly in the past few years, and the potential for counterproductive state regulation is coming closer to reality. The insurance industry uses information contained in the same credit reports used by other financial service providers, yet unlike consumers of the products provided by those related industries, consumers of insurance products must pay the price for compliance with a myriad of state restrictions.

In Allstate's view, the re-authorization of existing national uniform standards would be the ideal context in which to remedy this deficiency in the Fair Credit Reporting Act, thereby protecting consumers from the disruption and costs associated with inconsistent state regulation.

As Congress continues to examine the FCRA preemptions, we look forward to working with this Subcommittee in an effort to not only extend the existing preemptions, but also to find a solution to the problems created by the inconsistent and anti-competitive restrictions on the use of insurance scoring at the state level.

I would be happy, Mr. Chairman, to answer any questions that you or members of the Subcommittee may have. Thank you again for the opportunity to provide this testimony.

List of States with Requirements Impacting the Use of Credit Reports

The following states have imposed substantive restrictions and/or front end or back end notice requirements on the use of credit. While some of these restrictions and requirements are similar, many differ greatly from the others, and even slight differences from state to state require vast resources and incredible diligence on the part of an insurer to ensure compliance:

- Arkansas
- Arizona
- California
- Colorado
- Connecticut
- Delaware
- Florida
- Georgia
- Hawaii
- Idaho
- Illinois
- Indiana
- Iowa
- Kansas
- Kentucky
- Louisiana
- Maine
- Maryland
- Michigan
- Minnesota
- Missouri
- Montana
- Nebraska
- Nevada
- New Hampshire
- New Jersey
- New Mexico
- New York
- North Carolina
- North Dakota
- Ohio
- Oklahoma

- Oregon
- Rhode Island
- South Carolina
- South Dakota
- Utah
- Vermont
- Virginia
- Washington
- West Virginia
- Wisconsin